Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NED:BOS:TL-N-4278-99
MJGormley

date: NOV 30 1999

to: District Director, New England District
Attn: [redacted], Revenue Agent/Team Coordinator
IRS Group [redacted]

from: District Counsel, New England District, Boston

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subject: [redacted]
Surplus Note Interest

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

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FACTS

Reference is hereby made to your memorandum to this office dated June 23, 1999 regarding the above-described taxpayer. You have requested our advice concerning surplus note interest paid to [redacted] (Parent) by its wholly owned US subsidiary, [redacted] (US), [redacted](US). Specifically, you have asked whether the recipient of this interest, Parent, should have treated this interest as income not effectively connected with a US trade or business and therefore subject to a [redacted]% treaty rate of tax pursuant to I.R.C. § 881 for the years [redacted] and [redacted]. Alternatively, you have asked whether the payer of the interest, [redacted](US) is liable for a [redacted]% withholding tax under I.R.C. § 1442.

Based on the facts presented, Parent is a [redacted] insurance company which has operated a US [redacted] insurance branch for approximately [redacted] years. Both Parent and [redacted](US) are currently under examination for tax years [redacted] and [redacted]. [redacted](US) is a [redacted] company, while Parent is taxed as a [redacted] company. Beginning in [redacted], Parent issued certain surplus notes to [redacted](US) under which [redacted](US) agreed to and did pay interest. Interest payments were made at the end of each calendar year to the parent for the entire amount of interest that had accrued during each year, in US currency, and deposited in Parent's US bank account. Prior to [redacted], all such surplus note interest was treated as effectively connected income under I.R.C. § 842(a) by Parent and reported as income on its US Annual Statement and on its Form 1120L.

In December of [redacted], Parent moved certain of the surplus notes out of trusted status[1]. Parent now maintains that of the approximately $[redacted] dollars reported on either its annual statement or income tax return as effectively connected, $[redacted] should have been excluded from the total. You have reviewed the "Trusted Surplus Statements" filed with [redacted](US)'s [redacted] and [redacted] Annual Statements and have ascertained that the surplus notes related to the $[redacted] in interest did not appear on these statements. You are therefore satisfied that the $[redacted] should not have been reported as effectively connected for [redacted].

In the beginning of [redacted], Parent moved these surplus notes back into trusted status but towards the end of [redacted], again moved the same notes out. $[redacted] was reported as effectively

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[1]In determining whether income of a foreign [redacted] company is effectively connected with the conduct of a US business, the annual statement of its US business on the form approved by the National Association of Insurance Commissioners will usually be followed. <u>See</u> S. Rep. No. 1707, 89th Cong. 2d Sess., 38 (1966), P.L. 89-809 Committee Report. Foreign [redacted] Companies place assets pledged to support U.S. business in trust and may move these assets in and out of trust during the year and replace them with other assets, provided the total assets remain sufficient to support US business. For the period the asset is "trusted", the income is reported on the annual statement and is effectively connected.

connected income on the Parent's tax return, while $[redacted], the amount the taxpayer determined was not effectively connected, was not. The amount reported on the taxpayer's annual statement was $[redacted]. The entire amount of interest was paid by [redacted](US) with [redacted] checks dated [redacted] and [redacted], in the amounts of $[redacted] and $[redacted], respectively. The taxpayer has claimed that the surplus note interest that was not effectively connected in [redacted] and [redacted], $[redacted] and $[redacted], respectively, was exempt from tax as portfolio interest under I.R.C. 881(c), and therefore, it was not required to self-assess under I.R.C. § 881. You have questioned the applicability of the I.R.C. § 881(c) exception. Additionally, you have questioned whether the payer, [redacted](US), was liable for withholding taxes at the [redacted]% rate under I.R.C. § 1442.

LEGAL ANALYSIS

The U.S. tax imposed on a foreign company's income depends upon the source of the income and whether it is effectively connected with a U.S. trade or business. Generally, a foreign company engaged in a trade or business in the United States is taxed the same rates applicable to a U.S. business on that portion of their income that is effectively connected with the U.S. trade or business. I.R.C. § 882 (1). U.S. source income that is not effectively connected is subject to a 30% or lower treaty tax rate. I.R.C. 881. This can often be, but is not limited to, passive investment income. I.R.C. § 871(a)(1)(A); Treas. Reg. § 1.871-7(b)(1). Section 871(a)'s definition of passive investment income specifically includes interest.

A foreign corporation is required to segregate its gross income for the taxable year into two categories: income which is effectively connected for the taxable year with the conduct of a trade or business in the U.S. by that corporation and the income which is not effectively connected for that year. A separate tax is then determined upon each category. The determination of whether income is or is not effectively connected is made in accordance with I.R.C. § 864(c) and regulation §§ 1.864-3 through 1.864-7. See Treas. Reg. § 1.882-1(a). Foreign [redacted] insurance companies doing business in the United States are taxed as domestic insurance companies on their income effectively connected with their insurance business in the United States. Their noneffectively connected income is taxed at the flat 30% or lower treaty rate. I.R.C. § 881.

The taxpayer has claimed that it's noneffectively connected income is exempt from the provisions of I.R.C. § 881 because the income, the surplus note interest, that was paid was in fact portfolio interest and thus exempt. I.R.C. § 881(c) does provide for an exemption from the § 881 tax for portfolio interest. Portfolio interest includes original issue discount interest paid on an obligation in either bearer or registered form. However, it does not include interest received by a ten percent shareholder. See I.R.C. §§ 881(c)(3)(B); 871(h)(3)(B). For purposes of this rule, a 10% shareholder is, in the case of an obligation issued by a corporation, any person (or entity) who owns 10% or more of the total combined voting power of all classes of voting stock. As noted, parent is [redacted]% owner of [redacted](US).

A second exception to the § 881 taxation of noneffectively connected income is also inapplicable. I.R.C. § 881(d) refers to amounts described under I.R.C. § 871(i)(2) as also being exempt from the provisions of § 881. Here, the tax does not apply to interest on deposits held by an insurance company, in its capacity as an insurance company, under an agreement to pay interest on the deposits. It would apply to interest on policyholder's dividends left to accumulate, interest on prepaid premiums, on overcharged premiums, and on the proceeds of a policy left on deposit with an insurance company. See Rev. Rul. 77-231, 1977-2 C.B. 241. This exception, however, does not apply to interest paid on debt unless the debt arises by reason of a contract of insurance with the insurance company. In this case, the interest was paid on surplus notes which are generally considered to be debt for tax purposes. See Harlan v. U.S., 409 F.2d 904 (5th Cir. 1969)(surplus notes were debt where they had all the indicia of debt except for a contingency clause that disallowed payments on the notes unless the company held sufficient surplus). In addition, the surplus note arrangement generally involves one company issuing surplus notes, borrowing from the purchasers. The money the company receives from the purchasers increases assets, but not liabilities. While this increases surplus, it does not involve a contract of insurance with the insurance company. Based on all of the above, [redacted] does not qualify for the exemption under I.R.C. § 881(d).

With regard to the payer's obligation to withhold at the source, I.R.C. § 1442(a) requires that tax be deducted and withheld at the source on items of income paid to foreign corporations that were not effectively connected income in the payer's hands. There is however, an exemption contained in I.R.C. § 1442(b). This subsection provided that the exemption would apply where the withholding requirements impose an undue administrative burden on the interest and dividend payers, and where the collection of the tax would not be jeopardized by the exemption.

The regulations under this section provide guidance as to what constitutes an undue administrative burden. An undue administrative burden may be found where the person entitled to the income receives from the withholding agent income on securities, some of which are and some of which are not effectively connected; and, the criteria for determining the effective connection are unduly difficult to apply because of the circumstances under which the securities are being held. See Treas. Reg. § 1.1441-4(f)(1). It is clearly stated in the regulations that no exemption from withholding will be granted unless the person entitled to the income, here the Parent, complies with such other requirements as the District Director shall impose and unless the District Director is satisfied that the collection of the tax on the income involved will not be jeopardized by the exemption. Moreover, in order for the exemption to apply, the foreign corporation must file a statement with the District Director indicating why specified classes of income should be exempted from the withholding requirements. This statement must include the name and address of the withholding agent and of the person entitled to the income, the taxpayer's identifying number, the class of income to be exempted, the trade or business with which the income is in part effectively connected, the tax year involved, and the identity of the securities or other underlying property involved. The IRS may require a bond be posted in these cases. Treas. Reg. § 1.1441-4(f)(2). No such statement was filed in this case. Therefore, in accordance with I.R.C. §§ 1441, 1442 and the regulations thereunder, [redacted](US) had the obligation to deduct and withhold from the noneffectively connected income paid to Parent, a tax equal to the [redacted]% Treaty rate.

Conclusion

Based on all of the above, Parent and [redacted](US) have distinct and separate liabilities. Parent, as the recipient of the noneffectively connected surplus note interest, is liable for a [redacted]% treaty rate of tax and should have self-assessed in accordance with § 881. [redacted](US) as the payer of the interest should have withheld the tax, at the [redacted]% rate, at the source pursuant to § 1442. However, as you are aware, the liability can be collected only once, from either party. Following your meetings with the taxpayer and your issuance of Form 5701, Notice of Proposed Adjustments, Parent has recently indicated its agreement with your proposed adjustments and its willingness to pay the liability. We are therefore closing our file on this case. If you have any questions regarding this matter, please contact the undersigned at 617/565-7858.

MAUREEN T. O'BRIEN
Assistant District Counsel

By: [signature]
MICHELE J. GORMLEY
Senior Attorney